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CONSEQUENCES OF A BUSINESS LOSS

— by Neil E. Harl*

A business loss is not exactly welcomed but at least a net operating loss deduction may be available.[1] Net operating losses can be carried back three years (unless the election is made to carry the NOL forward only)[2] and forward 15 years.[3]

However, a net operating loss may have several subtle effects, most of which tend to be negative in nature.[4] As a matter of planning, these consequences should be figured into any effort before year end to avoid a net operating loss by delaying deductions or accelerating income.

Home office deduction

One notable consequence of a business loss is that the home office deduction[5] may not be available.[6] The home office deduction is limited to the excess of the gross income generated from the business activity conducted in the office less all other deductible expenses attributable to the activity which are not allocable to the use of the home office.[7] Thus, the home office expense deduction may not create or increase a net operating loss from the business activity to which it relates.[8] For example, personal interest income is not considered business income for a sole proprietorship even though the interest income is used to finance business operations.[9]

However, the gross income taken into account is not merely the gross income reported on Schedules F or C; it may also include income from property leasing, sales and management carried on in the home office and reported on other schedules.[10]

Health insurance costs

In recent years, self-employed individuals have been entitled to deduct 30 percent of the amount paid (25 percent before 1995) during the year for insurance which constitutes medical care for the self-employed individual, a spouse and dependents.[11] The deduction is limited to the self-employed taxpayer's "earned income"[12] "derived from...the trade or business with respect to which the plan providing the medical care coverage is established."[13] The term "earned income" is defined as the "net earnings from self-employment"[14] but "only with respect to a trade or business in which personal services of the taxpayer are a material income-producing factor."[15] The term "net earnings from self-employment" is defined as gross income earned by a taxpayer from a business carried on by the taxpayer less deductions allowed which are attributable to the business.[16] Therefore, a net loss for a farm or ranch business means that there may be no net earnings from self-employment.[17]

However, in the case of a trade or business carried on by an individual or a partnership, and in which, if the trade or business were carried on by employees, a "major portion" of the services would constitute agricultural labor[18]—

• For an individual, if the gross income from the trade or business is not more than $2,400, the net earnings from self-employment from the trade or business may, at the taxpayer's option, be deemed to be two-thirds of the gross income,[19] or

• For an individual whose gross income from the trade or business is more than $2400 and the net earnings from self-employment from the trade or business *are less than $1600*, the net earnings from self-employment from the trade or business may, at the taxpayer's option, *be deemed to be $1,600.*[20]

Similar rules apply to partnerships.[21]

For trades or businesses where a "major portion" of the services would not constitute agricultural labor, a special rule (for not more than five taxable years) applies if net earnings from self-employment are less than $1600 and less than two-thirds of the individual's gross income from all trades or businesses carried on by the individual.[22] In no event may net earnings from self-employment under this provision exceed $1,600.[23]

IRA contribution

A taxpayer may be eligible to claim a deduction for a contribution to an individual retirement account.[24] In general, the deduction may not exceed the lesser of $2,000 or an amount equal to the compensation includible in the taxpayer's gross income for the taxable year.[25] The term "compensation" is defined as earned income[26] which in turn is defined as net earnings from self-employment.[27] Therefore, the deductibility of an IRA contribution is subject to the same rules as for health insurance as discussed above.[28]

In conclusion...

In addition to the usual consequences of a net operating loss of losing personal and dependency exemptions,[29] any net operating loss carryback or carryforward,[30] nonbusiness

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deductions (except to the extent of nonbusiness income)[31] and nonbusiness capital losses (except to the extent of nonbusiness capital gains),[32] taxpayers run the risk of losing the home office deduction,[33] losing part or all of the deduction for an IRA contribution.[34] and the deduction for health insurance costs.[35] This would suggest careful attention to net income calculations before year end when there is still time to influence the level of income and deductions for the year.

FOOTNOTES

1 I.R.C. § 172. See generally 4 Harl, *Agricultural Law* § 30.10 (1996); Harl, *Agricultural Law Manual* § 4.05[4] (1996).
2 I.R.C. § 172(b)(3).
3 I.R.C. § 172(b)(1)(A).
4 *E.g.*, King v. Comm'r, T.C. Memo. 1996-231 (loss of deductibility of health insurance costs, home office expense and IRA contribution).
5 I.R.C. § 280A(a).
6 I.R.C. § 280A(c)(5).
7 *Id*. See King v. Comm'r, T.C. Memo. 1996-231; Grinalds v. Comm'r, T.C. Memo. 1993-66 (home office activity generated sufficient gross income for real estate developer to be allowed home office deduction and avoid loss limitations on deductions).
8 *Id*.
9 King v. Comm'r, T.C. Memo. 1996-231.
10 See Grinalds v. Comm'r, T.C. Memo. 1993-66 (depreciation on home office claimable even though Schedule C showed loss because taxpayer acquired, constructed, improved, leased, managed and sold commercial real property from home office which was reported on Schedules B, D and E; court held that, given taxpayer's leasing and sales activity, these amounts constituted business income).
11 I.R.C. § 162(l)(1).
12 See I.R.C. § 401(c)(1).
13 I.R.C. § 162(l)(2)(A). See generally 4 Harl, *supra* n. 1, § 28.02[6][d].
14 See I.R.C. § 1402(a).
15 I.R.C. § 401(c)(2)(A)(i).
16 See I.R.C. § 1402(a).
17 See King v. Comm'r, T.C. Memo. 1996-231.
18 See I.R.C. § 3121(g).
19 I.R.C. § 1402(a)(15)(i).
20 I.R.C. § 1402(a)(15)(ii).
21 I.R.C. § 1402(a)(15)(iii), (iv).
22 I.R.C. § 1402(a)(15).
23 *Id*. This point seems not to have been considered in the recent case of King v. Comm'r, T.C. Memo. 1996-231.
24 I.R.C. § 219(a). See Treas. Reg. § 1.219-1(a).
25 I.R.C. § 219(b)(1).
26 I.R.C. § 401(c)(2)(A).
27 See I.R.C. § 1402(a).
28 See ns. 17-22 *supra*.
29 I.R.C. § 172(d)(3).
30 I.R.C. § 172(d)(1).
31 I.R.C. § 172(d)(4).
32 I.R.C. § 172(d)(2).
33 I.R.C. § 280A.
34 I.R.C. § 219(a).
35 I.R.C. § 162(l).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-*ALM* § 13.03.*

DISCHARGE. The debtor was a logger who contracted with a third party to log trees under a 50/50 contract. The debtor checked the county records and discovered a right of way to the third party's land over the plaintiff's land. The debtor notified the plaintiff about the right of way and testified that the plaintiff allowed the use of a road for the logging operation because the right of way was over swampy land. The debtor also testified that the plaintiff agreed to the removal of trees on the plaintiff's land under the same 50/50 arrangement, although no written contract was executed. The plaintiff inspected the operation and complained about the damage to the road and, at a later inspection, discovered a large number of trees had been removed from the plaintiff's land. The plaintiff informed the debtor of the findings and forbid any future use of the road. The debtor complied with the request. The plaintiff claimed that the debtor received payment for the trees cut from the plaintiff's land but converted the payments to the debtor's personal use. After the debtor filed for bankruptcy, the plaintiff filed claims for the lost trees and damage to the road. The plaintiff then filed a motion to have the debts declared nondischargeable under Sections 523(a)(4) (larceny or embezzlement) or (a)(6) (malicious and willful injury). The court held that the debts were dischargeable because the plaintiff did not demonstrate any malicious actions by the debtor in removing the trees, damaging the road or failing to make payments under the contract. The court characterized the relationship of the parties as contractual with the plaintiff's damages as within the normal course of business between contract parties. ***In re* Hrim, 196 B.R. 237 (Bankr. N.D. N.Y. 1993)**.

PREFERENTIAL TRANSFERS. The debtors had owed money to the SBA. After that debt was due, the debtors contracted with the ASCS (now FSA) for conservation programs under which the debtors would receive annual deficiency payments. The SBA instituted an administrative setoff which was properly approved by the ASCS. Some payments were made within 90 days before the debtors filed for bankruptcy and the trustee sought recovery of these setoff payments as preferential transfers. The Appellate Panel held that the ASCS and SBA lacked mutuality so that the setoff was not binding in the bankruptcy case and ordered recovery of the payments. However, the court *en banc* reversed, holding that the United States was a unitary creditor for bankruptcy purposes. The case was remanded to the panel for determinations as to whether the setoff was allowed under